DOW THEORY LETTERS INC.

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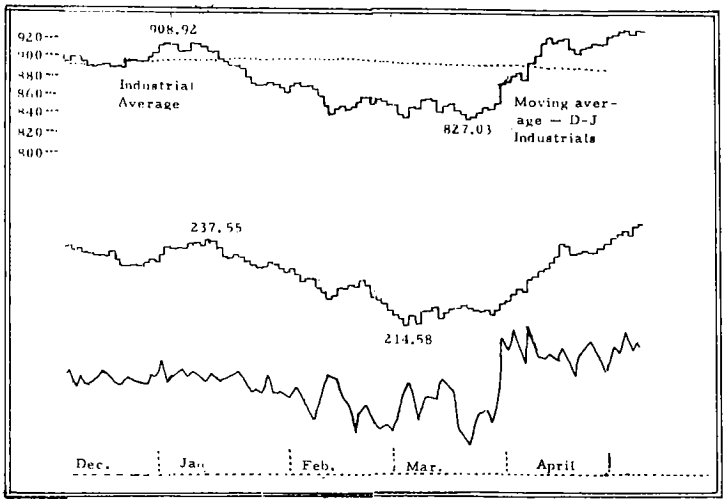
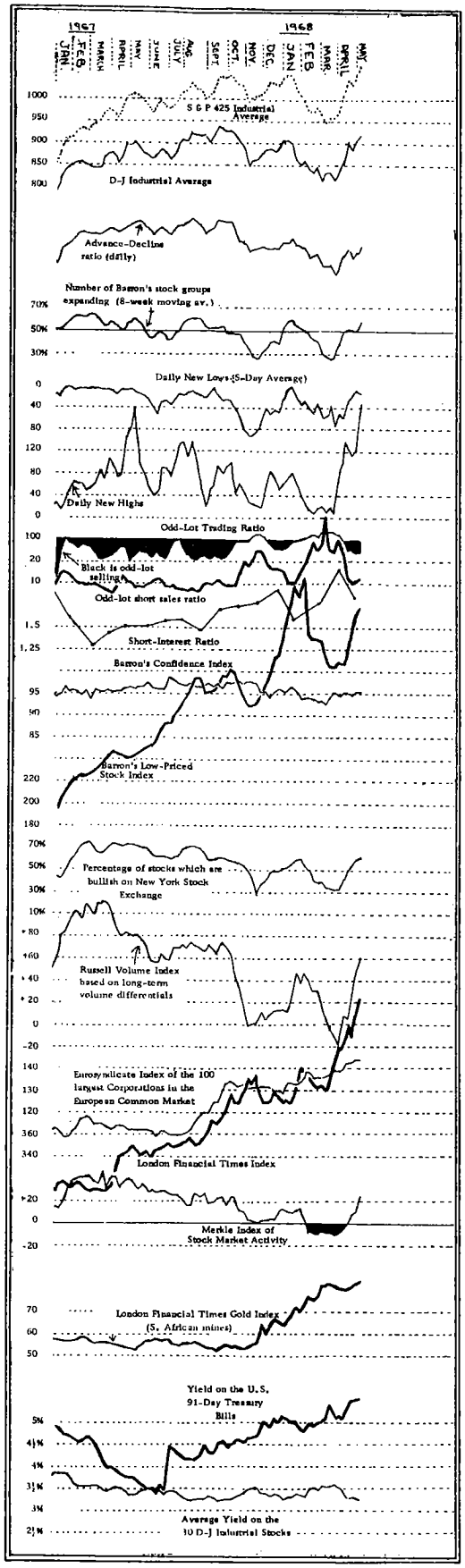
THE MARKET: Most people are totally unaware of it, but the forces of deflation are slowly rising to combat the forces of inflation. No doubt about it, inflation now holds the spotlight and makes the headlines. Hardly a week goes by without some labor union announcing a whopping new wage increase. Prices of services, medical, education, construction, almost everything else is rising. Latest statistics show that the cost of living in March jumped .4%, largest increase in eight months (taking the cost of living index 3.9% over March of 1967). From all accounts, inflation is sweeping over the nation.

But consider this; the cost of money is also inflating (rising) and that is deflationary. Here too, hardly a week passes witnout producing some new record for interest rates. For instance, on May 1 the U.S. Treasury offered a 6% rate on $11 billion of Government notes maturing in 1975, the first 6% rate in 48 years. Mortgage rates are climbing to the 7.5% range. U.S. 91-day Treasury bill yields are now at 5.5%, while yields on the D-J 40-Bonds are at an amazing 6.7%. The much bounced-about 10% surtax (with spending cuts), which is currently the "darling" of the Administration, is obviously deflationary, although LBJ prefers to label the tax bill as a dollar safeguard. Deflationary also is the minus reserve position into which the Federal Reserve Board has thrust the commercial banking system.

But the greatest forces for deflation are the desires and warnings of the U.S.'s foreign creditors regarding the stability of the dollar. Remember, the two-tier gold system (see Letter 290) provides the world with a barometer of the dollar, and as the price of gold continues to creep up, the foreign Central Bankers become increasingly nervous. Their nervousness can, at any time, be translated into demand for gold, and this constitutes a tremendous potential force for deflation.

Because the gold price is now near $40, the world knows that the dollar is selling at a premium of about 14% on the free market. To put it another way, the free market knows that it requires $40 to purchase




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 10 D-J Industrial Stocks

 an ounce of gold, regardless of the fact that the U.S. Treasury says that an ounce of gold is worth $35. The trend is increasingly towards dollar unacceptability. With gold rising in price, wouldn't you, as a foreign businessman, question the value of a large sale which was to be financed with dollars say three or six months from now?

The long-term or primary trend of the stock market turned bearish in February, 1966. As this primary bear market progresses, I believe the forces of deflation will expand in strength. Then, sometime in the next year or so, we will witness a period wherein the deflationary forces will flare up and finally overcome the forces of inflation. I do not know what will actually set off the deflationary tide. It may be an ending of the Vietnam war, it may be a surprise at election time, it may be action by the Central Bankers, it could be a stock market crash, it could be something from a totally unexpected quarter. But that is the way bear markets work. Bear markets are long-term periods of correction, deflation—times when the water is generally being squeezed out of the stock market and the economy.

What would happen, I am asked, if the dollar was devalued or if the price of gold were to be doubled or tripled by world consent? Wouldn't this be inflationary? The answer is that no one knows for sure. I believe that it is always dangerous to underrate the discounting ability of the stock market. Who can be sure that the market at its present high level is not already discounting a forthcoming devaluation? Who can say that upon actual devaluation news, the market would not plunge headlong to lower levels. After all, the dollar is already devalued by 14% on the free gold market (even while the stock market rallies). My own feeling is that an official devaluation could set off sharply lower stock prices (contrary to what everybody believes), and devaluation possibilities could well be what the market has been discounting in its refusal (so far) to sink to substantially lower levels.

* * * *

On May 3 a new ingredient was added to the general market outlook, and this was agreement that Paris would be the meeting place for the initial phase of negotiations between Hanoi and the U.S. But finding a meeting place acceptable to both sides is the easiest part of the coming U.S.—Hanoi "talk confrontation." Wall Street jumped on the news almost as if the whole question of Vietnam has been solved. But it has not been solved. In fact, no single problem actually relating to the war has been touched upon. All that has been settled is that the two sides have found a place in which they can sit down to talk in the view of the entire world.

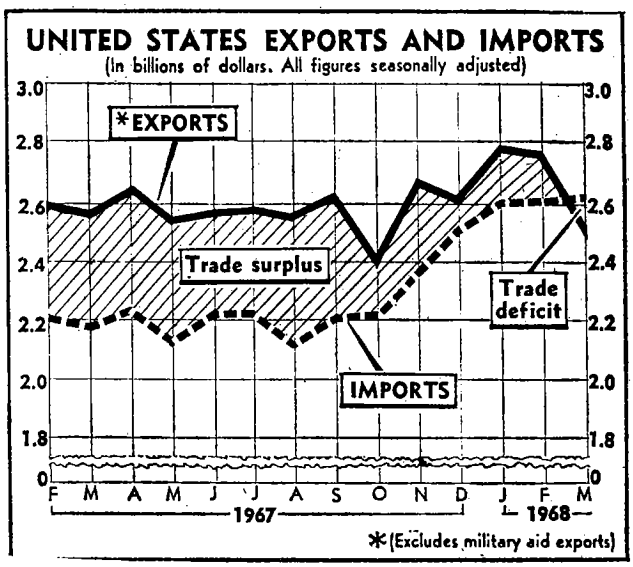
I thought economist Elliot Janeway provided an excellent comment on the situation (Janeway Service, May 1), and this was written just before the Paris agreement: "Talk and Fight. What is new and different about the situation created by Johnson's dramatic peace probe is that it has surfaced previous under-the-table goings on and clarified the situation for all to see. We had been talking and fighting all along, through every phase of the escalation; so had Hanoi; and so had all the 'would be' peace-and-trouble-makers (from England to China) on both sides of the fence. What has been clarified now that everyone can see what's going on is the fact—which it is—that no one knows where we are or where we are going—beginning with everyone at the top."

In my opinion, the American public is going to be shocked at how far apart the two sides are regarding any amicable agreement to terminate the war. Hanoi is going to ask for reparations, and these alone are going to be unacceptable to the U.S. At the very least, Hanoi will want political control of South Vietnam's political apparatus, and this too will be unacceptable. All in all, it is going to be both upsetting and a revelation when Hanoi begins laying out its demands. Picking the site for the public talks is the first and easiest step. From here on, the stock market is going to have to digest Vietnamese news of a much tougher order.

Meanwhile, the "good news" on Vietnam is obscuring the continuing dollar crisis. Most serious new development (touched upon last week) was the March deterioration in the trade balance to a $157 million deficit (see chart, page 3) the first such since 1962. Our long surplus trade balance had been, for years, the one bright spot in the total U.S. balance-of-payments picture. With the cave in of U.S. exports, as seen on the chart, a new and ominous pressure will be exerted on the U.S. It is going to affect many segments of the nation, from money rates to our bargaining position with the Communist nations. Should the trade deficit continue through April and May, we can expect drastic measures to emerge as the Administration attempts to reverse this picture.

With the exception of a final passing of the surtax, I feel that the good news (referring specifically to the Paris "peace site") is now out. From here on, Wall Street is going to have to look harder for bullish potentials, and for this reason I would expect the stock market to begin stalling or retreating.

Slowly but surely, almost all the analysts, commentators and the technical market indicators are turning bullish. And all this is occurring within the framework of a primary bear market. Frankly, I feel that what we are now seeing is the reverse of 1957 or 1962. At those times violent secondary (downward) reactions struck during a great bull market. Near the bottom of those reactions all of Wall Street was overwhelmingly bearish, the technical indicators all turned bearish and massive selling climaxes were seen.



But those collapses occurred within a primary bull market, and once bearishness reached an extreme, the bullish forces took hold again. Within a matter of months the Averages marched to new bull market highs. Reversing the situation, I feel that we are somewhere near an extreme of bullishness at this time. Most of the technical indicators are turning bullish, optimism is rising, Vietnam, the tax bill, corporate profits are all offering fodder for the bull fold. I would guess that the Averages will discount the best that will result from these hopeful situations over the next two or three weeks.

Once the upward correction has taken the Averages to the point where they have discounted the most bullish possibilities in the current and forthcoming picture, the primary bear market will again take hold. Despite the Presidential election towards the end of 1968, I would expect to see the market falter, back and fill, then head to lower levels by mid-summer.

Over the short term it is worth noting that the market (i.e., the advance-decline ratio) has pushed higher on 22 out of the last 26 days. This is a record, as far as my books are concerned. It implies that a "buying panic" has taken place and that the market is now heavily "overbought." This together with the record volume is perhaps the best measure of the fantastic optimism which has been created over the past few months within this primary bear market. It also suggests that the Averages have about discounted the best that can be seen ahead—discounted it in one, steady continuous upward sweep.

It would not surprise me to see the market work generally sideways now—perhaps for a number of weeks prior to the next important move. This, in the past, has been the pattern which has followed upside "buying climaxes," and I believe we can expect it to happen again.

* * * *

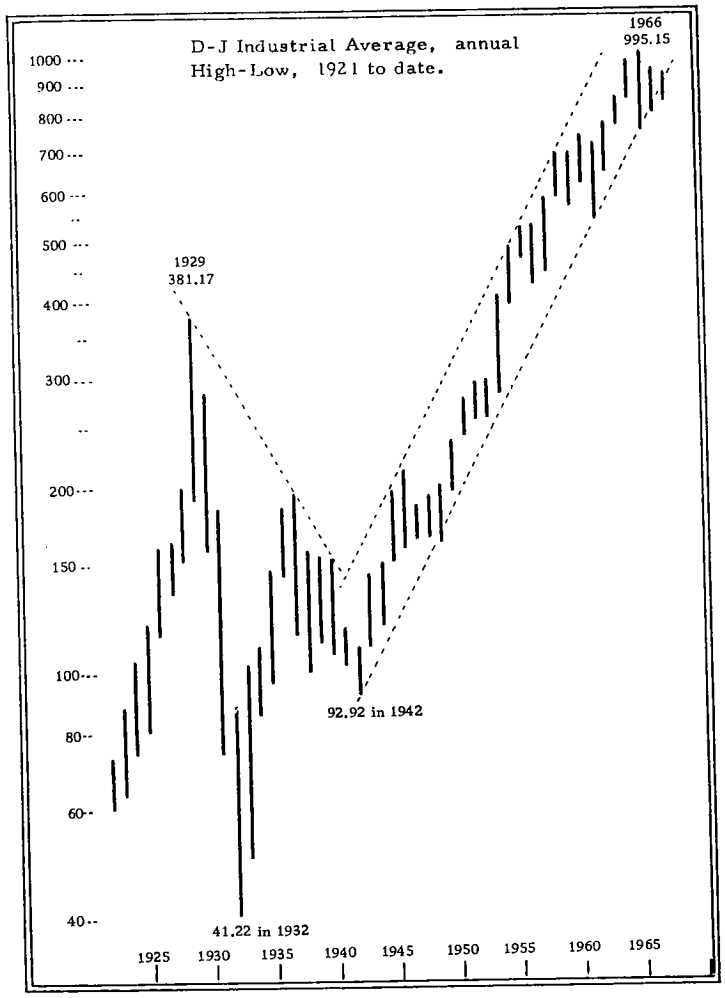
In the May 6 issue of Barron's, Edson Gould brings attention to his "three-step-and-stumble" rule. This is his rule which states that whenever there are three successive rises in any of the rates set by the monetary authorities (i.e., discount rate, reserve requirements, stock margins), the market is in the "danger zone."

The previous such signal set off in December, 1965, three months before the February, 1966 top. The latest three-step-and-stumble signal was triggered on April 18, 1968, following the third successive boost in the discount rate. The rationale for Gould's rule is simple enough. Whenever there are three successive rises in the rates set by the monetary authorities, it's clear that the Federal Reserve Board is slamming on the monetary brakes. Three separate actions imply that the authorities mean business, and in the past the market has taken heed of the Fed's intentions.

If the surtax bill is passed, it is possible that the discount rate will immediately be lowered, but in the meantime the three-step-and-stumble rule is in effect, and the warning is clear. So far, Gould's rule has never failed, and if this again holds true the general market should be in trouble in the period ahead.

BIG PICTURE: The accompanying chart (see page 4) is a semi-logarithmic representation of the high and low for the D-J Industrials from 1922 to date. Being semi-log, the chart measures the price movement in terms of percentages. In other words, a movement from 200 to 400 (a rise of 100%) would show on the chart as exactly the same distance as a rise from 300 to 600.

Here on the chart we see the great upward thrust from 1921 to 1929. Then the shocking collapse to the 1932 low of 41.22. Next came the rise to 194 in 1937, followed by the famous 92.92 low of 1942.



From 1942 the Dow turned up again, and what followed was the greatest and most persistent rise in Stock Exchange history. So steady was the rise, in fact, that the entire movement can be contained within a single upward channel. Even the 1946 bear market (which was subnormal in extent) failed to penetrate the lower trendline of the channel.

In 1967, following the 1966 bull market top of 995.15, a significant action occurred. The lower trendline of the channel was slightly penetrated when the Dow dropped to its 1966 low of 744.32. This was followed by the 1967 advance to 943.08 on the Dow. The final bar on the chart represents the year 1968 so far. Here again we see that the lower channel line was penetrated, this time more importantly than in 1967.

I consider the 1968 price movement as the first definite downside penetration of the channel which has now held for 26 years. I feel that the 1968 action is particularly significant since it has come at a time of great inflation, huge volume, and the most widespread public participation in Wall Street history. A new low (below the 1968 low) which might occur this year or in 1969 would take the Dow decisively below the channel for the first time since 1942. Such a penetration would, in my mind, mark the beginning of the real declining phase of the bear market which began in February, 1966.

A second item of interest on the chart is the fact that the years 1967 and 1968 (so far) have both been "inside years." By this I mean that the 1967 high and low were contained within the high-low limits of 1966. And so far, the 1968 high and low have been contained within the high-low limits of 1967. Such "compressed" action usually implies a powerful move ahead, and thus, the rest of this year could be unusually interesting.

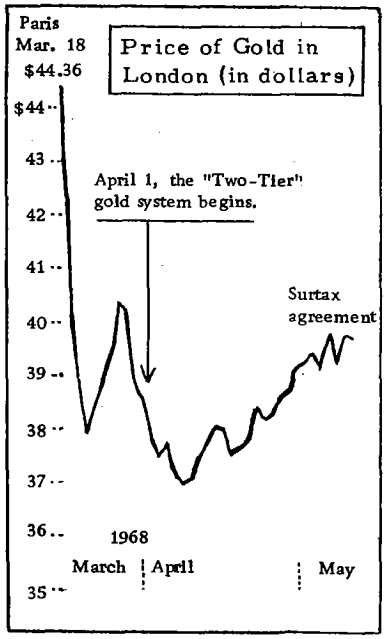
Note on the chart that only the price ranges during the years 1939 and 1947 were contained within the high-low limits of their preceding years. But in no case can we see three successive years in which each year's price action was confined within the limits of the preceding year.

Thus, the odds are extremely small regarding 1968 holding within the high-low confines of 1967. In fact, I would say that the odds are overwhelming that sometime in 1968 the Dow will either push above the 943.08 high of 1967 or below the 786.41 low of 1967.

VIETNAM: The latest of our Administration's "impossible dreams" is that South Vietnam will be able to take over the war while U.S. troops head for home. But this is really a dream, since the U.S. would hardly have over 500,000 men in Vietnam if anything like this was possible. Last week one of the S. Vietnamese senators spoke out as follows during the new draft law debate: "We have to appease American public opinion by showing that we are trying to do something" (Wash. Post, April 18). Peter Braestrup, reporting for the Wash. Post (April 15) out of Saigon wrote that ".....few U.S. or South Vietnamese see this (i.e., S.Vietnamese takeover of the war) as a practical proposition." He stated that if the U.S. troops pull out, the S. Vietnamese forces would have to abandon the five northern provinces including Hue and Danang "just to hold their own further South."

In the meantime, the partial cessation of bombing in North Vietnam may have more behind it than mere appeasement of Hanoi. Reporting in Foreign Affairs (April), former Assistant Secretary of State for Far Eastern Affairs Roger Hillsman notes that as of several months ago the bombing of the North was estimated to have cost the U.S. $6 billions

in aircraft "while the dollar value of the facilities destroyed in the North is estimated at $340 million." Hillsman further stated that "some experts argue that an end to the bombing might actually result in a military gain rather than a loss." Most of the targets, notes Hillsman, are destroyed at great danger to American flyers; furthermore, the majority of the targets are easily repaired (for instance, wooden bridges), often in a matter of hours.



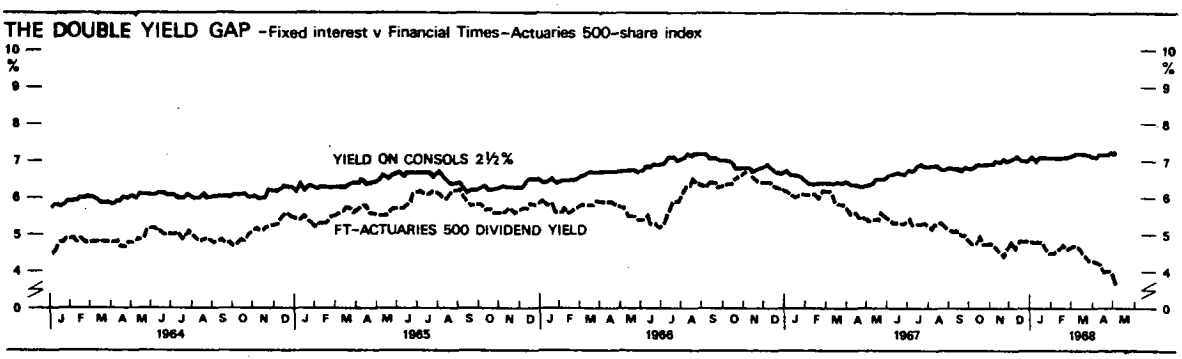
GOLD BAROMETER: I am updating the "Price of Gold" chart first shown in Letter 390. Here we see an interesting development. Despite the forthcoming Paris peace talks, despite the improving outlook for the 10% surtax with spending cuts, the free market price for gold has held remarkably steady (the rising trend is actually still in effect).

On May 6 the price of gold rose to a high of $39.75, the highest price since the two-tier gold system was inaugurated. A day later the House Ways and Means Committee recommended passage of the tax bill, but surprisingly in the face of this supposed bullish panacea for the dollar, the price of gold fell to only $39.22. The next day gold leaped back to the high of $39.75 as the gold stocks rallied.

Strangely, the free gold market has acted as if the improving chances for passage of the surtax meant nothing. The free gold has acted as if the coming Paris peace talks meant nothing. This is the value of the gold barometer. It is cold and unemotional. No flood of gold selling has hit the London market on any of last week's news. The big gold holders are continuing to hold, and the price creeps steadily higher.

Many analysts have ventured a "danger level" for the price of gold. The most frequently mentioned is "over $40 per ounce." My own guess, based on the chart, is that if gold pushes over the March peak of $40.50 and then goes into the $41 area, the gold market will be saying that the dollar is in real trouble. My guess also, is that any push over $41 would start the gold price accelerating on its own. In other words, the danger signal would be self actuating, bringing in new buyers and suggesting to the world that something is wrong. The gold story will be covered in detail in subsequent Letters. Meanwhile, let's all watch the quotes on the free gold price, as provided daily in the Wall Street Journal.

FLIGHT: There is no question about it, we are now witnessing a world flight from paper money. States the latest London Economist, "Again this week, the equity indicator in London has been going up as quickly as the Stock Exchange tower. The market is saying, in effect, that it does not believe that incomes restraint is going to work; that the price level this year will rise by much more than the official estimates; that money is a poor thing to hold; that dividend limitation doesn't much matter, because who wants income anyway? The little man, who kept his all in a building society or savings certificates, has latched on to unit trusts in a big way, and by shifting his savings is helping along the only market condition he has ever known, at least since July, 1966—endlessly rising prices."


THE DOUBLE YIELD GAP -Fixed interest v Financial Times-Actuaries 500-share index
10 %
9
8
7
6
5
4
0
YIELD ON CONSOLS 2½%
FT-ACTUARIES 500 DIVIDEND YIELD
J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M J J A S O N D J F M A M
1964
1965
1966
1967
1968

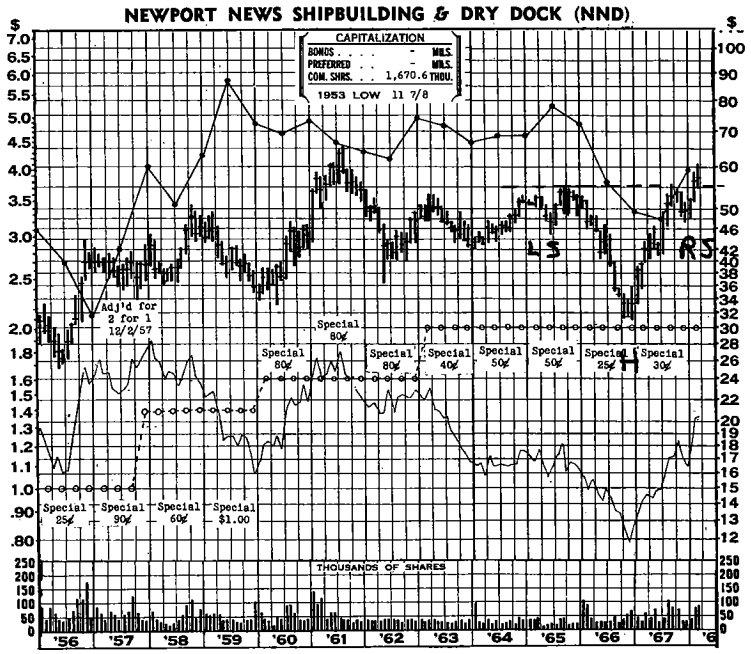
Then, as a warning, the Economist included the chart shown at the bottom of page 5. The consols are the 2½% bonds (they are perpetual or have no maturity date) of the British Government. The solid line shows the trend of the yield on Consols. The dashed line shows the yield on the British 500 stock index. Note that since 1967, the yield spread on the consols and stocks has widened to dangerous almost incredible proportions. On the basis of this, the Economist notes that "share prices now do look stretched to the full extent of any reasonable limit, and some of them beyond. This is the mounting conclusion of the sophisticated, big dealing institutions."

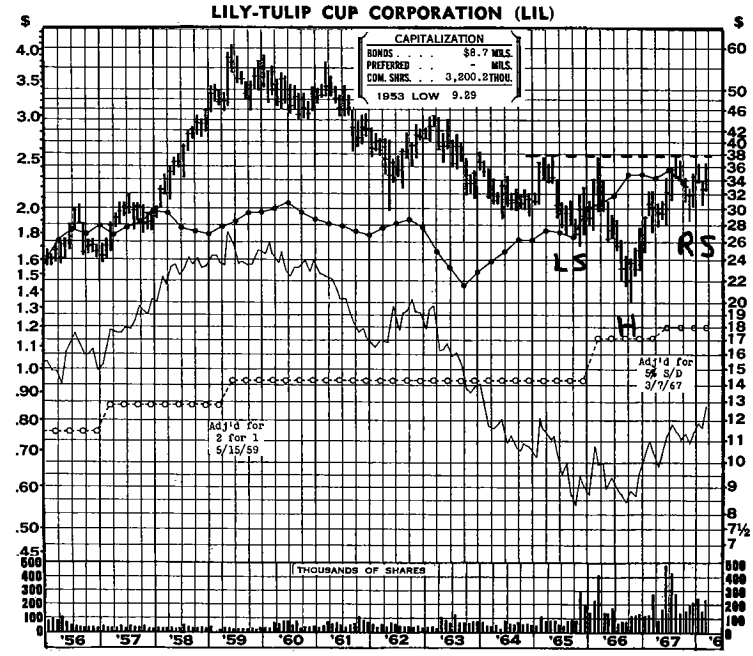
Of course, the same factors now apply to the U.S. market. This has become a "flight from paper money" affair, and any market based on fear is highly dangerous. Every inflationary bubble in world history has ultimately burst, and in my opinion, all the ingredients are now present for a bursting of the current bubble.

DOW THEORY MARKET LABORATORY PAGE

In reviewing hundreds of stock charts, I could not help but be struck by the two charts shown on this page. Here we see two "head-and-shoulder" reversal patterns, one in Newport News Shipbuilding, the other in Lily-Tulip Cup. NND has already broken above its neckline or resistance point at 55, while LIL has to go above 38 to break out and fulfill its chart pattern.

For those who have my suggested 10% to 15% (out of total assets) in gold, and for those who are tempted to speculate, these two stocks offer interesting possibilities. I am well aware that I have warned against speculation during a primary bear market. I am also well aware that perhaps one-third of my subscribers adhere 100% to my advice. So if you must get into this market and play for the upside (and I do not recommend it), at least I offer two stocks here which appear to have undergone major bullish reversals. (Charts courtesy of Securities Research, 208 Newbury St., Boston, Mass. 02116).




LILY-TULIP CUP CORPORATION (LIL)
CAPITALIZATION
BONDS . . . . $8.7 MLS.
PREFERRED . . . - MLS.
COM. SHRS. . . 3,200.2 THOU.
1953 LOW 9.29
LS
H
RS
Adj'd for 2 for 1 5/15/59
Adj'd for 5% S/D 3/7/67
THOUSANDS OF SHARES
'56 '57 '58 '59 '60 '61 '62 '63 '64 '65 '66 '67